Insurance Opportunities in 2009 and 2010 Tax Planning

By Tim Voorhees

The end of the year is tax planning time. This is a prime season of opportunities for insurance producers.

American public policy promotes zero-tax planning. The Internal Revenue Code rewards clients with substantial tax benefits when they facilitate the orderly transfer of their wealth to family members, business partners and charities.

Insurance professionals have routinely helped clients zero-out unnecessary estate and gift taxes. These advisors work with lawyers and CPAs to move money to irrevocable trusts and then let excess cash flow grow tax efficiently inside insurance policies and charities. Such transfer tax planning has grown more important as Congress has indicated that estate taxes will probably remain relatively high.

The most successful insurance advisors often combine transfer tax planning with income tax planning. Clients appreciate planners who know how to maximize both after-tax transfers to heirs and after-tax retirement income to the clients. These planners know how to illustrate the wealth planning tools that help clients improve after-tax income this year while providing more tax-efficient growth of wealth for the client's family and favorite charities.

The desire to reduce income taxes often motivates clients more than the need to lower estate taxes. Although most clients will acknowledge the desire to avoid the 45 percent estate tax, they are most likely to take action if they can lower income taxes in the current year.

Sharp advisors often apply a five-point analysis when looking for income tax planning opportunities. First, they help the client maximize business deductions. Second, they increase deductions for retirement plan contributions. Third, they show clients how to take large charitable deductions. Fourth, advisors spot opportunities to improve after-tax investment returns. Fifth, the advisors integrate tax-advantaged investments into plans.

Clients may express surprise when learning how life insurance instruments are some of the most powerful tools for improving after tax returns this year while building more wealth for children and other beneficiaries. The remaining part of this article will suggest how an adviser might use life insurance in each of the above five areas. Moreover, advanced life insurance applications can often help clients achieve benefits not available from traditional planning instruments. Here are brief descriptions of a few of the dozens of methods available for current income tax planning:

1. **Deducting premiums for a Captive Insurance Company ("CIC")**. Using a CIC, a business can receive tax deductions for funding a vehicle that provides property/casualty insurance for the business. Assets in the CIC can grow tax-efficiently if invested in life insurance. If the captive is integrated with other planning instruments, the excess capital in the captive can fund wealth transfer strategies. Clients can "eat well" because of the superior after-tax returns and also "sleep well" because the CIC insures against risks at rates typically not available through commercial insurance companies.

2. **Leveraging IRAs and profit sharing plans**. An individual with an over-funded retirement plan can generate tax-free retirement income and much larger after-tax inheritance numbers for heirs. Typical leveraging techniques involve the transfer of IRA money to a profit-sharing plan, which buys a life insurance policy and later sells the policy at a discount to grantor trust. Alternatively, clients can borrow the money to pay taxes on distributions and then use distributions to buy a life insurance policy that pays back the loans and distributes the balance to heirs. These programs require careful analysis to determine which clients can benefit from the specific tax advantages provided by the tax code. If designed properly, the leveraging programs can produce significant increases in after-tax retirement income and/or transfers to heirs.

3. **Giving money to charities while retaining income or other benefits**. A client can contribute securities, real property and other assets to a charitable remainder trust ("CRT") without recognizing current taxes. The contribution to the CRT generates an income tax deduction, allows for an estate tax deduction, permits the tax-free accumulation of assets and affords favorable tax treatment on distributions. The trustee, which can be the donor, has broad latitude in re-investing cash after selling a property in a CRT. The donor as income beneficiary can use the tax savings from the deduction and a portion of the CRT income to fund a "wealth replacement trust." This trust can own life insurance outside the estate to provide a benefit to the family that replaces the CRT assets that will pass to charity at the termination of the CRT.

4. **Investing tax-efficiently to avoid taxable income on Schedules B and D**. When clients study Schedules B and D of their personal income tax returns, they are often surprised to see how their mutual funds and other investments produce significant taxable returns. Their money managers often trigger taxes as part of the portfolio management and rebalancing process. Fortunately, however, wise insurance advisors know how to develop investment policy statements ("IPS") to help clients reduce taxes while possibly improving investment returns. An IPS can illustrate how an investor can stabilize a portfolio by putting a portion of the assets in an insurance policy with a low correlation relative to stock and bonds. The insurance policy can often accumulate assets tax free and even make tax-free policy loans. An investment proposal involving insurance can therefore suggest ways to reduce risk, minimize taxes and improve after-tax rate of returns on a portfolio.

5. **Funding insurance programs tax-efficiently**. Most clients fund insurance premiums with after-tax dollars. Advanced techniques allow for payment of premiums with pre-tax dollars. For example, an investor can borrow money to purchase insurance and then take tax deductions for the insurance premiums. Generally, loans taken to pay life insurance premiums are not deductible; however, if the arrangement meets specific criteria in the tax code, they can generate income tax deductions in the current year. Policies funded with the proceeds of these loans can generate benefits for heirs without estate or gift taxes.

The planning strategies listed in the above five areas are only a small subset of the techniques available. Readers should work with qualified tax professionals when designing and implementing plans that most appropriately integrate life insurance into tax planning programs. To help insure the appropriateness of the tax minimization strategies, advisors must take care to focus first on retirement security, family

wealth transfers, and other socially-beneficial objectives encouraged by the tax code. This emphasis on doing what is best for our clients and their families can often unite advisors in developing highly effective and tax efficient plans.